

Correlation between the Profitability and Working Capital Practices: A Case Study in the Gulf Cooperation Council

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Abstract

The ability of entrepreneurs to arrange working capital is the key to maximizing the profitability of small- and medium-sized enterprises and the wealth of entrepreneurs. The study investigates the correlation between entrepreneurs' working capital management and the profitability of SMEs listed on six Gulf Cooperation Council (GCC) stock exchanges between 2019 and 2020. The secondary data is collected from the financial statements of SMEs listed on the six GCC stock exchanges. Actual sample for the research study was a total of 136 small- and medium-sized enterprises selected using purposive sampling methods. Four research models were considered in this analysis, all ending up affecting gross profits. The selected entrepreneurial SMEs were listed on six different Gulf Cooperation Council stock exchanges during 2019–2020. The fixed financial assets ratio, financial debt ratio, and company size are used as control variables and data were analyzed using multiple regression. The research results demonstrate that there is a statistically significant negative correlation between profitability measured by gross profit and cash cycle and the components of the cash cycle (including days of accounts receivable and days of inventory). The study further reveals that there is no significant correlation between gross profit and days of accounts payable.

Keywords: Profitability, Working Capital Management, SMEs, Entrepreneurs, GCC

JEL Classification Code: G30, M40, M41, O53

1. Introduction

In the consumer goods sector, many competitors are offering the same products. Because of the similarity of the target market, small- and medium-sized enterprises are required to obtain maximum profits. Every SME has different marketing and internal strategies to convert production activities into fast cash flow. One of the strategies is the management accounting strategy, which focuses on maintaining an effective level of current assets and current liabilities to ensure that small and medium-sized enterprises

have sufficient cash flow to meet their short-term obligations (Akoto, Dadson, & Peter, 2013). Also, Khan (2016) pointed out that the method of adjusting working capital has a significant impact on the profitability of SMEs. It shows that a certain level of working capital requirements can generate the greatest profit. Zariyawati, Annuar, and Pui-Sanal (2016) also provided support for this. They explained that the goal of working capital management is to ensure that the company can continue by having sufficient cash flow to meet maturity, short-term and short-term operating activities. Developing effective working capital management will also ensure the company's financial health and help it build its business. Therefore, it is important to understand the decisive factors of working capital management to ensure that companies can withstand economic fluctuations in the long term.

In this case, the size of SMEs is also very important. Small- and medium-sized enterprises with low cash sales often encounter cash flow problems, while smaller companies focus on inventory management and conventional credit management (Howorth & Weshead, 2003). On the other hand, high-growth SMEs are unwilling to give credit to their customers. On the contrary, they save a lot of inventory capital. Having the best inventory level will directly affect working

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capital resources and investment in the business cycle. By managing appropriate expenditures during production and sales, small- and medium-sized enterprises will be able to control cash turnover, debt turnover and inventory turnover to generate maximum profits. Therefore, critical calculations and analysis are essential for understanding market demand and inventory management. Failure to properly perform working capital management will result in inefficiencies in operations, which will make SMEs unable to survive (Khan, Alkathiri, Alhaddad, & Alnajjar, 2021). Based on this background, the author of this article believes that the management of working capital has established a strong correlation between the cash cycle of SMEs and the profitability of SMEs. Therefore, this article aims to study the correlation between SME profits and management in the cash cycle. The main question of this study is to find the correlation between working capital management and the profitability of small- and medium enterprises listed on the GCC stock exchange during 2019–2020.

2. Literature Review

Working capital is the company's investment in short-term cash assets, treasury securities and accounts receivable (Brigham & Weston, 2010). Sufficient working capital can bring many benefits, such as (1) protecting SMEs from the impact of the crisis caused by the decline in the value of current assets; (2) allowing all debts to be repaid on time; (3) ensuring that, in the face of possible financial difficulties, SME needs credit; (4) providing sufficient inventory; (5) enabling SME to provide its customers with more favorable credit terms; (6) enabling SME to operate more efficiently because it is not difficult to obtain the required goods or services (Khan, 2019).

However, other working capital management and profitability studies have shown different results. Gill, Nahum, and Neil (2010) studied 88 small- and medium-sized companies listed on the New York Stock Exchange from 2005 to 2007 and found that the average payable day, average inventory day, company size, and profitability are not statistically significant. But notice that there is a negative correlation between accounts receivable and profitability. It suggests that managers can improve the company's profitability by reducing the number of days of accounts receivable. In theory, companies can maximize profits by controlling cash inflows and outflows and shortening the cash cycle. Brigham and Weston (2010) pointed out that the cash cycle can be shortened by (1) reducing the inventory conversion that can be obtained by processing and selling goods faster, (2) shortening the acceptance period by accelerating invoicing, or (3) extending the cash cycle. Suspend debt by slowing down payments.

The above research results show that the three components of the cash cycle and profitability are inconsistent. Some studies (Iswandi, 2012; Akoto et al., 2013; Gill et al., 2010) have found that cash turnover has no negative and significant

impact on profitability, while other variables (such as AR days, AP days) inventory days affect profitability. However, other studies have found that there is a strong negative correlation between the cash cycle and company profitability (Lazaridis & Tryfonidis, 2006; Deloof, 2003). This contradiction makes us interested in studying these variables and determining what impact these variables have on the consumer goods industry sector, which has become a basic demand in a society that continues to consume. Considering the important role of working capital in obtaining the best profits for SMEs, we believe that it is necessary to study the impact of working capital management on the profitability of SMEs listed on the Gulf Cooperation Council Exchange. Fixed financial assets ratio, company size (Ln assets), and the financial debt ratio are also considered important for measuring correlation or effect. Therefore, this research aims to determine and analyze the correlation between cash cycle management, accounts receivable management, debt management, and inventory management among the profitability of small- and medium-sized enterprises listed on the six GCC stock exchanges during 2019–2020.

3. Materials and Methods

The secondary data is collected from the financial statements of small- and medium-sized enterprises listed on the six GCC stock exchanges. Actual sample for the research study was a total of 136 small- and medium-sized enterprises selected using purposive sampling methods. The selected entrepreneurial SMEs were listed on six different Gulf Cooperation Council stock exchanges during 2019–2020. Further, the condition was that these SMEs have not been delisted during 2019–2020, and they did not suffer losses during the research period. The six different GCC stock exchanges referred are, namely, Bahrain Stock Exchange, Kuwait Stock Exchange, Oman-Muscat Stock Market, Qatar-Doha Stock Market, Saudi Arabia Arab-Saudi Stock Exchange (Tadawul), and UAE-Abu Dhabi Stock Exchange.

The descriptive analysis methods were used to analyze the data and the independent variables determined for this study are (1) cash cycle, (2) days of accounts receivable, (3) days of accounts payable, (4) debt turnover rate and (5) inventory days. The dependent variable of this study is gross profit, and the independent variable controls are (1) fixed financial asset ratio, (2) financial debt ratio, and (3) company size. A multiple regression analysis method is used, which was previously used to test the hypotheses and is a requirement for regression analysis testing. The purposive sampling method is used to select entrepreneurial SMEs listed on six different Gulf Cooperation Council stock exchanges during 2019–2020; the condition was that these SMEs have not been delisted during 2019–2020, and they did not suffer losses during the research period.

Table 1: Research Variables used to Test the Correlation Between each Variable

Variable	Nature of the variable	Measurement
Gross Profit (GrP)	Dependent Variable	Natural Logarithm of Gross Profit
Cash Cycle (CC)	Independent Variable	No. of days in AR + No. of days in inventory – No. of days in AP
No. of days in AR (ARD)	Independent Variable	(Account Receivable / Sales) * 365 days
No. of Days in Inventory (INVD)	Independent Variable	(Inventory / COGS) * 365 days
No. of Days in AP (APD)	Independent Variable	(Account Payable / COGS) * 365 days
Firm Size (FSz)	Controlling Variable	Natural Logarithm of Asset
Fixed Financial Asset Ratio (FA)	Controlling Variable	Fixed Financial Assets/Total Assets
Financial Debt Ratio (FD)	Controlling Variable	Total Liabilities/Total Asset

4. Results and Discussions

This study uses multiple regression analysis methods. This method is consistent with the previous research methods of Lazaridis and Tryfonidis (2006) and Gill et al. (2010). The multiple linear regression analysis models used are:

$$\text{Model 1: GrP} = b_0 + b_1 \text{ FA} + b_2 \text{ FD} + b_3 \text{ FSz} + b_4 \text{ CC} + \varepsilon \text{ random error component}$$

$$\text{Model 2: GrP} = b_0 + b_1 \text{ FA} + b_2 \text{ FD} + b_3 \text{ FSz} + b_4 \text{ ARD} + \varepsilon \text{ random error component}$$

$$\text{Model 3: GrP} = b_0 + b_1 \text{ FA} + b_2 \text{ FD} + b_3 \text{ FSz} + b_4 \text{ APD} + \varepsilon \text{ random error component}$$

$$\text{Model 4: GrP} = b_0 + b_1 \text{ FA} + b_2 \text{ FD} + b_3 \text{ FSz} + b_4 \text{ INVD} + \varepsilon \text{ random error component}$$

The hypotheses for the research study are:

H01: Fixed financial assets, financial debt, the size of small- and medium-sized enterprises, and the cash cycle have little effect on the dependent variable GrP.

H01: Fixed financial assets, financial debt, the size of small- and medium-sized enterprises, and the cash cycle significantly affect the dependent variable GrP.

H02: Fixed financial assets, financial debts, the size of SMEs, and days of accounts receivable have little effect on the dependent variable GrP.

H02: Fixed financial assets, financial debts, the size of SMEs, and the number of days of accounts receivable have a significant impact on the dependent variable GrP.

H03: Fixed financial assets, financial debts, the size of SMEs, and the number of days of accounts payable have little effect on the dependent variable GrP.

H03: Fixed financial assets, financial debt, the size of SMEs, and the number of days of accounts payable have a significant impact on the dependent variable GrP.

Table 2: Summarizing the Four Model Results

	Model	R	Adjusted R ²	Sig
1.	FA, FD, FSz, CC	0.936	0.870	0.000
2.	FA, FD, FSz, AR Days	0.921	0.841	0.000
3.	FA, FD, FSz, AP Days	0.917	0.834	0.000
4.	FA, FD, FSz, INV Days	0.936	0.870	0.000

H04: Fixed financial assets, financial debts, the size of SMEs, and inventory days have little effect on the dependent variable GrP.

H04: Fixed financial assets, financial debts, the size of SMEs, and inventory days significantly affect the dependent variable GrP.

The test criteria performed were:

- i. Accept H0 and reject H1 if Sig(α) > 0.050.
- ii. Reject H0 and accept H1 if Sig(α) < 0.050.

It can be seen from the results that all research models show Sig(α) < 0.050. It can be concluded that these four models significantly affect gross profit. The first model aims to determine the impact of CC and control variables on the gross profit of the dependent variable Ln. The results show that there is a strong correlation between the CC, FA, FD, FSz variables and the dependent variable GrP (according to the Tersine correlation table, the R of the known equation is 0.936). The adjusted R² value is 0.870, which means that 86.8% of gross profit can be explained by CC, FD, FA and FSz. The second model aims to determine the effect of ARD and variable control on the dependent variable GrP. Knowing that the R obtained by the equation is 0.921 (according to the Tersine table), the analysis shows that there is a high

correlation between ARD, FA, FD, FSz and the dependent variable GrP. The adjusted R^2 value is 0.841, which means that ARD, FD, FA and FSz can explain 84.0% of the gross profit.

The third model study is to study the influence of APD and variable control on the dependent variable GrP. According to the Tersine correlation table, the result R of the equation is 0.917, and the result shows that there is a significant correlation between the APD, FA, FD, FSz variables and the dependent variable GrP. The adjusted R^2 value is 0.834, which means that APD, FD, FA and FSz can explain 83.3% of the gross profit. A fourth model study was conducted to test the variable control of INVd and GrP. According to the analysis, according to the Tersine correlation table, the R derived from the equation is 0.936. It can be seen that there is a high correlation between the INVd, FA, FD, FSz variables and the dependent variable GrP. The adjusted R^2 value is 0.870. This means that INVd, FD, FA and FSz can explain 86.9% of gross profit. Ali and Faisal (2020) show that the debt-equity ratio is not improving profitability, utilization of resources of petrochemicals companies of Saudi Arabia. Based on these data, the study formed the following first regression equation:

$$Y = 1.020 - 1.107 FA - 1.232 FD + 0.972 FSz - 0.003 CC$$

It can be concluded from the equation that if the values of CC, FSz, FD and FA are equal to 0, then GrP will increase by 1.020, and the effect on GrP is not obvious. An increase in the FA ratio will reduce GrP because the correlation is negatively significant (1,107). This means that if one small and medium enterprise incorporates assets into another small and medium enterprise, it will result in reduced profits. This shows that the level of return obtained is less than the opportunity cost. An increase in the FD ratio will reduce GrP because the correlation coefficient is negatively significant at (1.232). This means that third-party funds provide more opportunities than SMEs to make money.

An increase in FSz will increase GrP because the correlation coefficient is positively correlated at 0.972. This means that if SMEs are larger, it will increase profits for SMEs. The equation also shows the negative correlation between CC and GrP. This is consistent with the view that the reduction of CC or cash cycle will bring greater profits to the company. When the capital flow of SMEs increases, the working capital used will be less. Based on these data, the study formed the following second regression equation:

$$Y = -0.572 - 0.924 FA - 1.155 FD + 1.015 FSz - 0.003 ARD$$

Table 3: Equation Model 1

	Unstandardized Coefficients		Standardized Coefficients	<i>t</i>	Sig.
	<i>B</i>	Std. Error	Beta		
(Constant)	1.020	1.281		0.796	0.428
FA	-1.107	0.401	-0.106	-2.763	0.007
FD	-1.232	0.315	-0.150	-3.916	0.000
FSz	0.972	0.043	0.850	22.392	0.000
CC	-0.003	0.001	-0.198	-5.148	0.000

Dependent Variable: GrP.

Table 4: Equation Model 2

	Unstandardized Coefficients		Standardized Coefficients	<i>t</i>	Sig.
	<i>B</i>	Std. Error	Beta		
(Constant)	-0.572	1.393		-0.411	0.682
FA	-0.924	0.440	-0.088	-2.099	0.038
FD	-1.155	0.347	-0.141	-3.327	0.001
FSz	1.015	0.048	0.888	21.342	0.000
AR	-0.003	0.001	-0.084	-2.016	0.046

Dependent Variable: GrP.

It can be seen from the equation that if the values of ARD, FSz, FD, and FA are equal to 0, GrP will decrease (0.572), and the effect on GrP is not obvious. An increase in FA correlation will lead to a decrease in GrP because the correlation is negative at (0.924). This means that, if one small- and medium-sized enterprise incorporates assets into another small- and medium-sized enterprise, it will result in reduced profits. It will also show that the rate of return obtained is less than the opportunity cost. An increase in the FD ratio will decrease GrP because the correlation coefficient is negatively significant at (1.155). This means that third-party funds provide more opportunities than SMEs to make money. An increase in FSz will increase GrP because the correlation coefficient is positively correlated at 1.015.

This means that the size of SMEs will affect profits. If the scale of SMEs is larger, it will increase profits for SMEs. This equation also shows a negative correlation of (0.003), which has a significant impact on ARD and GrP. This means that the reduction in the number of days in the accounts receivable turnover cycle will increase the profits of the SME. If SMEs receive receivables from their customers, more working capital can be used for SME operations. Based on these data, the study formed the following third regression equation:

$$Y = -1.549 - 0.828 FA - 1.093 FD + 1.043 FSz - 0.001 APD$$

It can be concluded from the equation that, if the values of APD, FSz, FD and FA are equal to 0, GrP will continue to decrease (1.549), and the effect on GrP will not be significant. An increase in the FA ratio will lead to a decrease in GrP because the correlation coefficient is negative (0.828) and the effect is not obvious. This means that if one small and medium enterprise incorporates assets into another small- and medium-sized enterprise, it will result in reduced profits. This also shows that the rate of return earned is less than the opportunity cost.

Table 5: Equation Model 3

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	-1.549	1.336		-1.160	0.249
FA	-0.828	0.446	-0.079	-1.855	0.066
FD	-1.093	0.352	-0.133	-3.101	0.003
FSz	1.043	0.046	0.912	22.496	0.000
AP	-0.001	0.002	-0.012	-0.288	0.774

Dependent Variable: GrP.

Table 6: Equation Model 4

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	0.621	1.249		0.497	0.620
FA	-1.036	0.398	-0.099	-2.602	0.011
FD	-1.194	0.314	-0.145	-3.808	0.000
FSz	0.987	0.042	0.864	23.251	0.000
INV	-0.004	0.001	-0.193	-5.190	0.000

Dependent Variable: GrP.

An increase in the FD ratio will result in a decrease in GrP because the correlations are all negative and significant (1.093). This means that the cost of funds from third parties is higher than the opportunity cost of profit. Also, an increase in FSz will increase GrP because the correlation coefficient is 1.043 positive correlation. This means that the larger the SME, the more profit it can make. This equation shows that there is a negative correlation around 0.001, and its effect is not significant (between APD and GrP). This means that reducing one day in the debt rotation cycle will increase the profits of SMEs. Although the result is trivial, it is in line with the assumption that small- and medium-sized enterprises will be able to use their working capital to operate and create profits by delaying debt repayment.

Based on these data, the study formed the following fourth regression equation:

$$Y = 0.621 - 1.036 FA - 1.194 FD + 0.987 FSz - 0.004 INVD$$

It can be seen from the equation that if the values of INVD, FSz, FD and FA are equal to 0, GrP will continue to increase by 0.621, and the effect on GrP will not be significant. An increase in the FA ratio will result in a decrease in GrP because the correlation is negatively significant (1.036). This means that if a small- and medium-sized enterprise incorporates assets into another small- and medium-sized enterprise, it will reduce its profits. This shows that the rate of return obtained is less than the opportunity cost. An increase in the FD ratio will reduce GrP because the correlation is negatively significant (1.194). This means that funds obtained from third parties are higher than the opportunity cost of making money for SMEs. An increase in FSz will increase GrP because the correlation coefficient is significantly positive 0.987. This means that if the scale of SMEs is larger, it will increase the profits of SMEs. This equation shows that there is a negative correlation of 0.004 between INVD and GrP, which has a significant impact. This result is consistent with the study of Khan and Al Mamari (2019). The reduction

in inventory turnover days will lead to increased profits for SMEs. This shows that longer inventory storage in the warehouse will increase the cost of storing goods, thereby reducing the profits of SMEs.

5. Conclusions

This study aims to determine the impact of working capital management on the profitability of SMEs listed on six GCC stock exchanges during 2019–2020. The variables used in this study are a dependent variable (gross profit), fixed financial asset ratio, debt-to-asset ratio, and three variables (expressed as the natural logarithm of assets). The independent variables tested are cash cycle, accounts receivable turnover rate, debt turnover rate, and inventory turnover rate. Research shows that in the first test model, the cash cycle with three control variables has a significant impact and negative correlation. This is consistent with the following view: a decrease in CC will lead to an increase in SME profits, because the speed of capital flow in SMEs increases, which means that the use of working capital is reduced. This result is consistent with the study of Lazaridis and Tryfonidis (2006) and Khan (2016), which found that the negative correlation between accounts receivable and company profitability indicates lower profit companies because it will seek to reduce its accounts receivable to try to reduce its cash gap. Therefore, managers can create profits for small- and medium-sized enterprises by correctly handling the cash cycle and keeping each of the different components (accounts receivable, accounts payable, inventory) at an optimal level.

The second model uses accounts receivable days calculations with three control variables, showing a significant impact and negative correlation. This means that the reduction in the turnover days of accounts receivable will lead to an increase in the profits of SMEs. This result echoes the research of Gill et al. (2010) and Pham et al. (2020) based on the assumption that the faster SMEs receive receivables from their customers, the more working capital can be used for SME operations. Credit policy is a method used to attract new customers to generate large sales. Therefore, to maximize working capital, it is necessary to maintain a balance between accounts receivable and controlling the turnover of accounts receivable. This is consistent with the study of Pattiruhu and Paais (2020), which shows that ROA has a positive and significant impact on the company policy. It is possible to accelerate the turnover of accounts receivable by providing incentives to consumers, so that consumers can repay their debts to SMEs. Incentives can be short-term payments or cash discounts.

The third model uses accounts payable days calculation with three control variables, which shows that there is a negative correlation and its impact is not significant. This means that a one-day reduction in the debt rotation cycle will lead to increased profits for SMEs. Although the result is trivial, it is in line with the following assumption: the

longer the SMEs delay debt repayment, the more SMEs will use their working capital to operate and generate profits. The fourth model uses inventory days with three control variables, showing a significant impact and negative correlation. This means that the reduction in the number of days in the inventory turnover cycle will result in a significant increase in company profits. This indicates that longer inventory storage in the warehouse will increase the cost of storing goods, thereby reducing the profits of small and medium enterprises.

SME can manage its inventory in the best quantity to reduce the cost of inventory storage. We hope that managers or decision-makers can understand and analyze the stability of accounts payable-accounts receivable and cash flow to control the maximum profitability. If the inventory is fully stacked due to decreased sales, it will be risky for the SME because there will be some damaged goods and expired goods. Small and medium enterprises are required to have good inventory management and accurate sales strategies to generate the greatest level of profit.

This study has limitations relative to the research object because it only targets small and medium-sized enterprises engaged in the consumer goods industry. It is expected that future research will focus not only on the components of working capital management but also on the external components of SMEs, such as economic conditions, inflation rates and foreign currency exchange rates. When deciding to purchase raw materials, product prices, and profit levels of SMEs from abroad and domestic (export/import), these components should be checked to determine what impact they have on the behavior of SMEs.

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